DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS NUMBER: 98-0010 ITC
GROSS AND ADJUSTED GROSS INCOME TAX
For Years 1992, 1993, 1994, AND 1995

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ISSUES

I. Gross Income Tax – Treasury Stock

Authority: 45 IAC 1-1-32; 45 IAC 1-1-50; 45 IAC 1-1-51; 45 IAC 1-1-119; IC § 6-2.1-1-2; IC § 6-2.1-3-3; *Hoosier Energy* 528 N.E.2d 867 (Ind. Tax 1988); *Complete Auto Transit, Inc. v. Brady* (1977), 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326

Taxpayer protests assessment of gross income tax on receipts from the issuance of treasury stock.

II. Gross Income Tax – Distributive Shares

Authority: 45 IAC 1-1-51; 45 IAC 1-1-159.1; IC § 6-3-2-2

Taxpayer protests assessment on the distributive share from gross receipts of a corporate partner.

III. Gross Income Tax – Computational Error

Authority: None cited.

Taxpayer protests assessment of gross income tax on receipts from sales made to partner by taxpayer. Taxpayer maintains certain amounts assessed in this category were erroneously double counted in computing gross income.

IV. Gross Income Tax – Resource Recovery System

Authority: IC § 6-2.1-4-3

Taxpayer seeks a deduction-based on environmental compliance costs for expense associated with a resource recovery system.

V. Adjusted Gross Income Tax – Foreign Source Dividends

Authority: IC § 6-3-2-12

Taxpayer protests the disallowance of 15% of its foreign source dividend deduction.

VI. Adjusted Gross Income Tax –Attribution of Payroll Expenses

Authority: IC § 6-3-2-2

Taxpayer protests reattribution of certain payroll expenses from taxpayer's payroll factor to a related corporation's payroll factor.

VII. Adjusted Gross Income Tax –Intercompany Transfers

Authority: None cited.

Taxpayer protests the disallowance of deductions for intercompany transfers taken on its Indiana consolidated returns.

VIII. Adjusted Gross Income Tax – Nonbusiness Income

Authority: None cited.

Taxpayer protests department's reclassification of nonbusiness income.

IX. Adjusted Gross Income Tax – Treasury Stock Receipts

Authority: IC § 6-3-1-3.5; IC § 6-3-1-24; IC § 6-3-2-2; Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996)

Taxpayer protests inclusion of treasury stock receipts in taxpayer's sales factor.

X. Gross and Adjusted Gross Income Tax –Research Expense Credit

Authority: None cited.

Taxpayer protests the Calculation of Research Expense Credit.

XI. Gross and Adjusted Gross Income Tax – Negligence Penalty

Authority: 45 IAC 15-11-12; IC § 6-8.1-10-1

Taxpayer protests negligence penalty assessment.

STATEMENT OF FACTS

Taxpayer is a multinational corporation based in Indiana. Taxpayer receives income from sources within Indiana, national, and foreign investments; likewise, taxpayer's expenses are incurred at manufacturing operations located in Indiana and the United States as well as international locations.

I. Gross Income Tax – Treasury Stock

DISCUSSION

Taxpayer's initial contention is that treasury stock-i.e. stock originally issued by taxpayer and reacquired by taxpayer in the course of business- should be considered equivalent to new issue stock. Taxpayer notes IC § 6-2.1-1-2(c)(14), which states:

> (c) The term "gross income" does not include:
> ….
> (14) the receipt of capital by a corporation, partnership, firm, or joint venture from the sale of stock or shares in such corporation, partnership, firm, or joint venture, or contributions to the capital thereof;

while IC § 6-2.1-1-2(e) tempers such exclusion:

> The exclusion provided by subsection (c) clause (14) does not apply to proceeds that are derived from subsequent transactions in stock of such corporations or organizations or in the interest or shares of the members of any organization.

Taxpayer does not cite IC § 6-2.1-1-2(a)(9), which defines gross income to include gross receipts:

> From the surrender, sale, transfer, exchange, redemption of, or distribution upon, stock of corporations or associations;…

Despite the explicit exclusion provided and the inclusion of the transactions in question in the statute defining gross income, taxpayer argues that by its nature, treasury stock should be treated as equivalent to new issue stock. Taxpayer does not address 45 IAC 1-1-32 Income from transfer of stocks, which states in relevant part:

> Gross receipts from the sale, transfer or exchange of corporate stock are not subject to tax when received by the corporation from the original issue of its own stock nor from subsequent original issues. However, subsequent transactions in the corporation's own stock, including the sale of treasury stock which has been issued, repurchased or otherwise acquired and then sold, result in taxable gross receipts.

Nor does taxpayer address the language of the exemption itself that states "the receipt of capital…" is excluded. Capital, as defined by Blacks Law Dictionary, Fifth Edition, includes- but is by no means limited to- "the sum total of corporate stock." When taxpayer makes an initial issue of stock, the money raised by its sale would constitute capital raised for the business. Subsequent transactions, as with treasury stock, do not constitute new capital or new additions to taxpayer's total issued stock value, merely the purchase and sale of stock as contemplated by IC § 6-2.1-1-2(a)(9).

Taxpayer's initial contention that treasury stock should be considered equivalent to new issue stock is not supported by statute. Taxpayer then argues that the term "proceeds" in IC § 6-2.1-1-2(e) does not include "gross receipts" from subsequent transactions. Granting, in arguendo, taxpayer's argument that "proceeds" are not equivalent to "gross receipts", it fails, inasmuch as the exclusion referenced by the IC § 6-2.1-1-2(e) does not include the treasury stock transactions, which fall under the statutory definition of gross income in IC § 6-2.1-1-2(a)(9). The argument that an exemption to an exclusion is applicable to the taxation of a transaction identified by a separate statute as taxable is not persuasive.

As taxpayer further notes in its argument, even if the treasury stock transactions are not considered equivalent to new issue stock, some not all transactions involving treasury stock still may be exempt. In some transactions, employees are allowed to exchange stock for treasury stock at a discounted value. Taxpayer notes that IC § 6-2.1-1-2(c)(16) states:

> (c) The term "gross income" does not include:
> ….
> (16) the gross receipts represented by the value of stock of a corporation or association received in a reciprocal exchange by and between the owners of the stock (including the issuing corporation or association) for stock in the same corporation or association to the extent of the value of the stock or the interest therein of which title is surrendered;

Taxpayer's gross income therefore should exclude gross receipts "to the extent of the value of the stock or the interest therein of which title is surrendered " in transactions where taxpayer's employees exchange stock for treasury stock.

Taxpayer presents two related arguments involving out-of-state transactions involving the treasury stock. Taxpayer uses treasury stock as compensation for out-of-state employees working at out-of-state locations, as well as conducting sales of the treasury stock at out of state brokerages and stock exchanges. Taxpayer argues that these transactions are not part of its Indiana gross receipts due to a lack of Indiana nexus.

Taxpayer cites 45 IAC 1-1-50 Out-of-State Business of Indiana Residents, which states in relevant part:

> The Gross Income Tax Act specifically exempts from taxation those transactions of a domestic corporation which are connected with a trade or business situated and regularly carried on at a legal situs outside the state or from activities incident thereto…

Taxpayer fails to note the following regulation, 45 IAC 1-1-51 Situs of Intangibles, which states:

> The department applies two tests in determining the taxability of income from intangibles. The term "intangible " or "intangible property," as used in IC 6-2-1-1(m) [Repealed], means and includes notes, stocks in either foreign or domestic corporations, bonds, debentures, certificates of deposit, accounts receivable, brokerage and trading accounts, bills of sale, conditional sales contracts, chattel mortgages, "trading stamps," final judgments, leases, royalties, certificates of sale, choses*(sic)* in action and any and all other evidences of similar rights capable of being transferred, acquired or sold.
>
> The first test is what may be termed the "business situs" of the taxpayer or the relationship of the income from the intangible to the business activity of the taxpayer in Indiana. If the intangible or the income derived therefrom forms an integral part of a business regularly conducted at a situs in Indiana, the total gross income derived from the sale, assignment, transfer or exchange of the rights comprising the intangible property, or from interest, finance charges, dividends or other earnings upon the intangibles of any kind, or from any other source arising from the ownership of intangible property, or from the transfer of ownership to another will be required to be reported for taxation under IC 6-2-1-1(m) [Repealed] at the higher rate under IC 6-2-1-3(g). The test of a "situs" has been defined in Regulation 6-2-1-1(m)(330) and out of-state-business is discussed in Regulation 6-2-1-1(m)(340) [45 IAC 1-1-50].

Therefore, if a taxpayer has a "business situs" in Indiana, as defined by Regulation 6-2-1-1(m)(330) [45 IAC 1-1-49], and the intangible or the income derived therefrom is connected with that business, either actually or constructively, the gross receipts of those intangibles will be required to be reported for gross income tax purposes.

In addition to the case where the owner of the intangible is doing business in Indiana and the intangibles form an integral part of such owner's business conducted at or through his "business situs" in Indiana, a taxpayer may also be liable for gross income tax from intangible if he is deemed to have established a "commercial domicile" in Indiana. Thus the second test is what may be termed the "commercial domicile" of the taxpayer.

A taxpayer may have many business situses, but has only one commercial domicile. Where that is located must be determined based on all of the facts. Generally speaking, a commercial domicile may be viewed as the location of the majority of all the taxpayer's activities or business. The commercial domicile may also be called the "nerve" center" or "corporate center" of all the business functions of the taxpayer.

If a taxpayer's commercial domicile is in Indiana, all of the income from intangibles will be taxed under IC 6-2-1-1(m) [Repealed] except that income which may be directly related to an integral part of a business regularly conducted at a "business situs" outside Indiana. The Department will look to the following types of activities and the location of such activities of a taxpayer in determining the "commercial domicile"; however, such list is not all-inclusive:

(1) location of management and administrative activities connected with each location, such as policy and investment decisions;
(2) location of board of directors' meetings;
(3) residence of executives and their offices;
(4) location of books and records;
(5) location of payment on income from intangibles of the taxpayer; and
(6) information from annual and quarterly reports of the taxpayer.

If a commercial domicile is established in a state other than Indiana, no income from intangibles will be taxed under IC 6-2-1-1(m)[repealed-now 6-2.1-1-2, 6-2.1-2-8, 6-2.1-4-2, 6-2.1-5-9, 6-2.5-5-5(a), 6-2.5-1-6] unless the taxpayer has also established a business situs in Indiana and the intangible income derived therefrom forms an integral part of that Indiana activity.

….

> Examples of transactions in intangibles which are partially or wholly excluded from taxation are: … Sales which are totally nontaxable as transactions in interstate commerce (IC 6-2-1-7(a) [Repealed])…. The issuance of bonds or stocks, except with respect to treasury stock (IC 6-2-1-7(a) [Repealed])….

Taxpayer's corporation is based in Indiana and states in its Memorandum in Support of the Protest, received by the Department on 12/21/99, page 16 "[Taxpayer] is an Indiana corporation and is commercially domiciled in Indiana."

The application of the above regulation require the taxation of "all of the income from intangibles will be taxed …. except that income which may be directly related to an integral part of a business regularly conducted at a "business situs" outside Indiana." Taxpayer does not demonstrate how the income from the transfer of treasury stock for a corporation in Indiana, even if the stock transaction ultimately benefits or compensates an out of state employee, is income "directly related to an integral part of a business regularly conducted at a "business situs" outside Indiana." Taxpayer's contention that this should be read to mean that despite the location of taxpayer's commercial situs in Indiana, any income from the corporation's stock that has any connection to an out-of-state business situs is not taxable is not supported.

The final argument made by taxpayer involves 45 IAC 1-1-119(1)(e), which states the following are nontaxable:

> Sales of stock to nonresidents made through Indiana or nonresident brokers. See Freeman v. Hewit 329 U.S. 249 (1946); also margin transactions and dealings in commodities futures carried on through securities exchanges in other states. See Indian Dep't of State Rev., Gross Income Tax Div. v. Nebeker, 23 Indiana 58, 116 N.E.2d 104 (1953)

This regulation is superseded by IC § 6-2.1-3-3, which exempts from gross income tax gross income "… to the extent the state of Indiana is prohibited from taxing that gross income by the United States Constitution." 45 IAC 1-1-119 is an enumeration of the constitutional parameters as established by case law. These cases were overturned by the U.S. Supreme court in *Complete Auto Transit, Inc. v. Brady* (1977), 430 U.S. 274, 97 S.Ct. 1076, 51 L.Ed.2d 326 as summarized by the Indiana Tax Court in *Hoosier Energy* 528 N.E.2d 867 (Ind. Tax 1988). This development was reflected in the regulations issued and in force presently. The statute imposes the gross income tax to the extent it is permitted by the Constitution. The regulation sought to codify this extent. The Supreme Court subsequently reversed the decisions relied upon in the regulation; consequently, the statute imposes a boarder imposition of the gross income tax than the regulation would indicate. When a statute and regulation conflict, the statute is controlling.

Taxpayer then argues that the acquisition costs of the stock was used to value the transactions, taxpayer argues that the value received is the correct measurement. The operative statute defining these transactions as taxable is IC § 6-2.1-1-2(9), which states:

> From the surrender, sale, transfer, exchange, redemption of, or distribution upon, stock of corporations or associations;…

The statute explicitly identifies the income to be taxed as coming from the distribution, not acquisition, of the stock. The value of the treasury stock should be based on the gross receipts from the disposal of the treasury stock. This issue is discussed and denied in issue IX, Treasury Stock Receipts, and the analysis in that issue is applicable to this circumstance.

FINDINGS

Taxpayer protest is sustained as to transactions involving exchanges of stock between employees and the company, the remainder of the protest is denied.

II. Gross Income Tax – Distributive Shares

DISCUSSION

Taxpayer maintains the appropriate regulation for determining the apportionment of income received as a corporate partner was 45 IAC 1-1-159.1. The auditor allocated the intangibles or interest income based on 45 IAC 1-1-51.

Review of the two regulations reveals an explicit reference in 45 IAC 1-1-159.1, which requires the inclusion of a "sales factor" as defined by IC § 6-3-2-2. 45 IAC 1-1-159.1 states in relevant part:

> For purposes of this subsection, all income of the partnership shall be considered business income. If a partnership does business in a state besides Indiana, a partner's distributive share of partnership income which is derived from sources within Indiana, for gross income tax purposes, shall be determined by multiplying the partner's distributive share by a fraction. The numerator of the fraction shall be the sum of:
>
> (1) the property factor
> (2) the payroll factor; and
> (3) the sales factor;
>
> of the partnership. The denominator of the fraction shall be determined by the number of factors used. The property factor shall be determined under IC 6-3-2-2(c). The payroll factor shall be determined under IC 6-3-2-2(d). The sales factor shall be determined under IC 6-3-2-2(e) and IC 6-3-2-2(f).

IC § 6-3-2-2 states in relevant part:

> (e) Sales include receipts from intangible property and receipts from the sale or exchange of intangible property…. Receipts from intangible personal property are derived from sources within Indiana if the receipts from the intangible personal property are attributable to Indiana under section 2.2 of this chapter….
> (f) Sales, other than receipts from intangible property covered by subsection (e) and sales of tangible personal property, are in this state if:
> (1) the income producing activity is performed in this state; or
> (2) the income producing activity is performed both within and without this state and a greater proportion of the income producing activity is performed in this state than in any other state, based on costs of performance.

45 IAC 1-1-51 discusses at length the attribution of intangible income to an entity based on the entity's business situs or commercial domicile. (See the discussion under issue 1) 45 IAC 1-1-51, Situs of Intangibles, states:

> The department applies two tests in determining the taxability of income from intangibles….

Essentially the auditor treated the income from the partnership to the taxpayer as intangible income, which was its nature when flowing into the partnership, rather than treating it as partnership income to the taxpayer. The regulation taxpayer cites requires, by direct reference, the computation of income from intangibles-both in and out of state-as part of the calculation of the taxpayer's partnership income, while the regulation cited by the auditor applies only to the taxability of taxpayer's intangible income, not the computation of the attributive share of the taxpayer's partnership income. Consequently, 45 IAC 1-1-159.1 governs the computation of partnership income from intangibles and not 45 IAC 1-1-51. To this extent, taxpayer protest is sustained and audit is instructed to allocate the partnership income based on 45 IAC 1-1-159.1.

FINDING

Taxpayer protest sustained.

III. Gross Income Tax – Computational Error

DISCUSSION

Taxpayer's protest encompassed multiple aspects of a set of transactions; in summary, the majority of this protest focused on areas that involved refund issues. The taxpayer's

protest did not clearly articulate a specific protest of an audit adjustment. Nor was the taxpayer clear in requesting a claim for refund. No supplemental changes can be made based on the documentation supplied.

FINDING

Taxpayer protest denied.

IV. Gross Income Tax – Resource Recovery System

DISCUSSION

Audit denied the resource recovery deductions claimed by taxpayer pursuant to IC 6-2.1-4-3. The auditor required a statement certifying the equipment from the Indiana Department of Environmental Management (hereinafter "IDEM") which taxpayer was unable to present at the time. Taxpayer presents three arguments in support of the deduction. First taxpayer asserts that an equipment system deemed to be for environmental compliance is deductible per statute absent any statutory exclusion. Second, the taxpayer has now presented a certificate of certification, such as was required by the auditor, from IDEM. Third, the taxpayer protested the exclusion of the deduction based on an "Agreed Order" by IDEM involving the equipment and the Department's denial of the deduction in question.

The statute at issue, IC § 6-2.1-4-3, states in relevant part:

> (a) For purposes of this section:
> ….
> "Resource recovery system" means tangible property directly used to dispose of solid waste or hazardous waste by converting it into energy or other useful products.
> ….
>
> (b) If for federal income tax purposes a taxpayer is allowed a depreciation deduction for a particular taxable year with respect to a resource recovery system, and if the resource recovery system processes solid waste or hazardous waste, the taxpayer is entitled to a deduction from his gross income for that same taxable year. The amount of the deduction equals the total depreciation deductions that the taxpayer is allowed, with respect to the system, for that taxable year under Sections 167 and 179 of the Internal Revenue Code.
>
> (c) Notwithstanding subsection (b), a taxpayer is not entitled to the deduction provided by this section for a particular taxable year with

> respect to a resource recovery system that is directly used to dispose of hazardous waste if during that taxable year the taxpayer:
>
> ….
>
> (2) is subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute governing the treatment, storage, or disposal of hazardous wastes that had a major or moderate potential for harm.

The auditor's reliance on IDEM certification is not supported by statute. The legislature was cognizant of the potential overlap of interest between IDEM and the Department in this area as is evidenced by the explicit requirement to deny the deduction based on actions by IDEM or other environmental regulatory agencies in subsection (c)(2). Rather than place the determination of the deductibility of the equipment in question with IDEM, the legislature provided a statutory definition of the equipment in question under subsection (a) of the statute that does not require an outside agency's confirmation for the department to evaluate or for the taxpayer to provide to claim the deduction.

Inasmuch as taxpayer provided an IDEM certification, albeit for the wrong year and location, the discussion of its applicability is mooted by the above finding.

Taxpayer's next contention is that the deduction should not be denied pursuant to IC 6-2.1-4-3(c)(2) because an Agreed Order did not explicitly find a violation by taxpayer. The taxpayer argues that the order was "(1) … a settlement decree that was not based on any determination of a violation of federal or state statute, rule, or regulation, and (2) [the deduction should not have been denied] for tax year 1995 because Agreed Order [omitted] had been satisfied and was no longer effective for that year." Taxpayer Protest received 12/21/99 by department page 27.

The Agreed Order, copy provided by taxpayer with the 12/21/99 protest, states:

> 5. …(p) Pursuant to 40 CFR 262.34, referencing 40 CFR 265.193(c)(3), secondary containment systems must be provided with a leak detection system capable of detecting leaks within twenty-four (24) hours. Based on information gathered by the IDEM, the secondary containment for the five (5) T-99 tanks and ancillary equipment was not provided with a leak detection system capable of detecting leaks within twenty-four (24) hours.
>
> ….
>
> 13. Within thirty (30) days of the effective date of the Order, Respondent shall provide a leak detection system, capable of detecting leaks within twenty-four (24) hours, for the secondary containment and ancillary equipment of the five- (5) T-99 tanks. Respondent shall submit documentation of compliance to the IDEM.
>
> …
>
> 18. Without admitting or denying liability, Respondent agrees to pay a Civil Penalty of $25,000. Said Penalty amount shall be due and payable to the

> Environmental Management Special Fund within thirty (30) days of the effective date of this Order as directed by Paragraph #20.

Taxpayer relies upon the language in provision 18, where taxpayer declined to admit or deny liability in support of taxpayer's argument that the Agreed Order was not based on a violation. Numerous citations within the Agreed Order contradict this assertion. In the sample above, section 5(p) specifies an absence of equipment constituting a violation of a cited regulation, while section 13 outlines the required remedial action, in this instance the installation of the required equipment. IC § 6-2.1-4-3(c)(2) does not require an admission of liability, it requires taxpayer to be "…subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute governing the treatment, storage, or disposal of hazardous wastes that had a major or moderate potential for harm." The absence of a finding of liability in this order does not alter the explicitly stated basis for the order, nor does it effect the taxability of the equipment.

Taxpayer submitted a copy of the letter of resolution from IDEM regarding the above referenced Agreed Order. This letter, submitted with the taxpayer protest received by the Department on 12/21/99, states in relevant part:

> Based upon documents available to the Office of Enforcement staff during a record review on January 9,1995, and the results of a reinspection conducted at your facility on December 9,1994, it has been determined that [taxpayer] has achieved compliance with the terms of the Agreed Order issued to your firm on May 17, 1994.

While the letter confirms the release of the Agreed Order, this release did not occur until January 9, 1995- the date of the final review of taxpayer's documents. IC § 6-2.1-4-3(b)(1) states in relevant part,

> …a taxpayer is not entitled to the deduction provided by this section for a particular taxable year with respect to a resource recovery system that is directly used to dispose of hazardous waste *if during that taxable year* the taxpayer:
> ….
> (2) is subject to an order or consent decree based upon a violation of a federal or state rule, regulation, or statute *(emphasis added)*

Taxpayer was subject to the Agreed Order for at least 9 days of the taxable year in question. The statute explicitly requires the loss of deduction for being subject to an order "during that taxable year." Taxpayer facility was subject to the Agreed Order in 1995 and thus is not permitted the exemption.

FINDING

Taxpayer protest denied.

V. Adjusted Gross Income Tax – Foreign Source Dividends

DISCUSSION

In calculating its Indiana tax liabilities, taxpayer, pursuant to IC 6-3-2-12, deducted foreign source dividend income from its Indiana adjusted gross income. Audit, however, disagreed with taxpayer's calculus. Specifically, Audit discovered that taxpayer failed to reduce its foreign source dividend income deduction by the sum of all expenses related (deemed or otherwise) to the earning of such dividend income. To "cure" this oversight, Audit, "netted" taxpayer's dividend deductions by all related expenses. Re-calculation resulted in an increase in taxpayer's Indiana adjusted gross income and tax. Proposed assessments of Indiana adjusted gross income tax followed.

Taxpayer, in response, contends the language of IC 6-3-2-12 neither commands nor suggests reducing the foreign source dividend deduction by related expenses. To buttress its contention, taxpayer directs the Department's attention to the language of IC 6-3-2-12(b), which states:

> A corporation that includes any foreign source dividend in its adjusted gross income for a taxable year is entitled to a deduction from that adjusted gross income. The amount of the deduction equals the product of:
>
> (1) the amount of the foreign source dividend included in the corporation's adjusted gross income for the taxable year; multiplied by
>
> (2) the percentage prescribed in subsection (c), (d), or (e), as the case may be.

The aforementioned subsections (c), (d), and (e) allow corporate taxpayers to receive a one hundred percent (100%) deduction for foreign source dividends received from corporations in which a taxpayer has an eighty percent (80%) or larger ownership interest; an eighty-five percent (85%) deduction for dividends received from corporations in which a taxpayer has a fifty to seventy-nine percent (50%-79%) percent ownership interest; and a fifty percent (50%) deduction for dividends received from corporations in which a taxpayer has less than a fifty percent (50%) ownership interest. IC 6-3-2-12(c)-(e).

Taxpayer argues that reducing its foreign source dividend deductions by related expenses effectively prevents taxpayer from deducting these statutorily mandated amounts (i.e., percentages). Taxpayer also notes that conspicuously absent from Indiana's taxing scheme is any statutory or regulatory language authorizing the Department, or requiring the taxpayer, to "addback" expenses related to the earning of excluded (i.e., deducted) foreign source dividend income.

The Department finds merit in taxpayer's arguments. Simply stated, IC 6-3-2-12 authorizes pro rata deductions (based on the percentage ownership of the payor by the payee) of certain foreign source dividend income. Neither IC 6-3-2-12 nor any other statute or regulation requires this pro rata deduction to be reduced by related expenses. Absent such authority, the statutorily mandated pro rata deduction may not be "adjusted."

FINDING

Taxpayer's protest is sustained.

VI. Adjusted Gross Income Tax – Attribution of Payroll Expenses

DISCUSSION

Taxpayer protests the removal of compensation paid to individuals from the numerator and denominator of its payroll factor and the transfer of these amounts to a subsidiary corporation's payroll factor. Taxpayer cites IC § 6-3-2-2(d), which states:

> The payroll factor is a fraction, the numerator of which is the total amount *paid in this state during the taxable year by the taxpayer for compensation*, and the denominator of which is the total compensation paid everywhere during the taxable year. However, with respect to a foreign corporation, the denominator does not include compensation paid in a place that is outside the United States. *(Emphasis added)*

Taxpayer argues that the staff in question, as noted in the emphasized segment above, were paid in Indiana by taxpayer and consequently the statute requires their addition to taxpayer's payroll factor.

In making the adjustment, the auditor relied on IC § 6-3-2-2(m), which states:

> In the case of two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests, the department shall distribute, apportion, or allocate the income derived from sources within the state of Indiana between and among those organizations, trades, or businesses in order to fairly reflect and report the income derived from sources within the state of Indiana by various taxpayers.

The issue involves "two (2) or more organizations, trades, or businesses owned or controlled directly or indirectly by the same interests," IC § 6-3-2-2(m), and the auditor's decision was supported in the audit report- cited but not discussed by the taxpayer- as "[t]he basis of this adjustment represents the methodology under which the taxpayer has

reported its Indiana Business Income." Taxpayer argues that for this transaction an ad hoc variation in Taxpayer's overall reporting of its Indiana Business Income is required.

The auditor cited appropriate statutory authority to make this adjustment. Taxpayer's exclusive reliance on IC § 6-3-2-2(d) is incorrect given IC § 6-3-2-2(m).

FINDING

Taxpayer protest is denied.

VII. Adjusted Gross Income Tax – Intercompany Transfers

DISCUSSION

Taxpayer notes that the adjustments were made to two entities (hereinafter identified as taxpayer and subsidiary corporation). Taxpayer's protest is based on an argument that these adjustments were not double deductions. After review of the returns, the auditor concurs that the adjustments on the taxpayer's return were not supported. However, the adjustments for the subsidiary corporation were taken by taxpayer without explanation or supporting information. No error has been identified. Therefore, absent any justification for these adjustments, taxpayer protest is denied.

FINDING

Taxpayer's protest is sustained, subject to audit verification, as to taxpayer corporation and denied as to the subsidiary corporation.

VIII. Adjusted Gross Income –Nonbusiness Income

DISCUSSION

Taxpayer asserted two entities of taxpayer (hereinafter the holding company and the subsidiary) had business income reclassified as nonbusiness income. Taxpayer protested requesting an explanation for the adjustments and/or their removal. The holding company reclassification was based on the 15 percent foreign dividend expense-rendered moot by the finding in Issue VI- and an income adjustment based on the finding of a non-unitary relationship. The subsidiary's income reclassification actually resulted in a decrease to taxpayer's nonbusiness income- the adjustment was a positive adjustment to a deduction. With the holding company, the protest of the 15% dividend expense adjustment is sustained based on the earlier finding in this LOF. The finding of a non-unitary relationship for the holding company is supported by findings within the Audit report and is consequently denied.

FINDING

Taxpayer protest of the income reclassification is sustained for the foreign dividend addback for the holding company, the protest is denied for the holding company adjustment based on the non-unitary relationship and for the subsidiary.

IX. Adjusted Gross Income –Treasury Stock Receipts

DISCUSSION

Audit included treasury stock receipts in the sales factor of the apportionment formulas used to calculate taxpayers adjusted gross income. Taxpayer questions these adjustments.

Taxpayer argues that inasmuch as IC § 6-3-1-3.5 requires "adjusted gross income" as defined in the Internal Revenue Code and modified by IC § 6-3-1-3.5 be used as the starting value for the calculation of a taxpayer's Indiana Adjusted Gross Income tax liability, the inclusion of treasury stock receipts in taxpayer's sales factor as applied to taxpayer's Adjusted Gross Income Tax should also be governed by these IRS provisions.

While Taxpayer notes IC § 6-3-1-24 defines "sales" as "all gross receipts of the taxpayer not allocated under IC § 6-3-2-2(g) through IC § 6-3-2-2(k)," the Department recognizes IC § 6-3-2-2, the controlling statute for this issue, which states in relevant part:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> …
> (5) *income from stocks*, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property *if the receipt from the intangible is attributable to Indiana under section 2.2 of this chapter*.
> …
> (e) The *sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year,* and the denominator of which is the total sales of the taxpayer everywhere during the taxable year. *Sales include receipts from intangible property and receipts from the sale or exchange of intangible property*. However, with respect to a foreign corporation, the denominator does not include sales made in a place that is outside the United States. *Receipts from intangible personal property are derived from sources within Indiana under section 2.2 of this chapter*. *(emphasis added)*

IC § 6-3-2-2.2, cited in IC § 6-3-2-2 also discusses income sources attributable to Indiana. This statute states in relevant part:

> Interest income, discounts, and receipts attributable to state
> …
> (g) Receipts in the form of dividends from investments are attributable to this state if the taxpayer's commercial domicile is in Indiana.

Taxpayer's corporation is based in Indiana and states in its Memorandum in Support of the Protest, received by the Department on 12/21/99, page 16 "[Taxpayer] is an Indiana corporation and is commercially domiciled in Indiana."

The application of the above statute requires the taxation of stock transactions for a corporation commercially domiciled in Indiana. There is no reference in the above statutes to the IRS code as determinative to these calculations and no linkage has been provided by taxpayer.

The taxpayer next argues that the auditor's adjustment was based on the auditor's theory that receipts from treasury stock transactions that are subject to Gross Income Tax should be included in the sales factor. Taxpayer's contention that regulations applicable to the Gross Income Tax should be read to mean that despite the location of taxpayer's commercial situs in Indiana, income from the corporation's stock that has any connection to an out of state business situs is not taxable under the Adjusted Gross Income Tax is not supported.

Taxpayer then cites Sherwin-Williams Co, v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996) as support for the exclusion of the treasury stock receipts. This case deals exclusively with receipts from investments- not stock transactions- of an out-of-state taxpayer, and is not applicable to the issue at hand.

Taxpayer also protests that the acquisition costs of the stock was used to value the transactions. Taxpayer believes the value received is the correct measurement of the stock value. Inasmuch as the operative statute defining these transactions as taxable is IC § 6-3-2-2, which-as noted earlier- states in relevant part:

> (a) With regard to corporations and nonresident persons, "adjusted gross income derived from sources within Indiana", for the purposes of this article, shall mean and include:
> …
> (5) *income from stocks*, bonds, notes, bank deposits, patents, copyrights, secret processes and formulas, good will, trademarks, trade brands, franchises, and other intangible personal property...

The statute identifies the income to be taxed as coming from the distribution, not acquisition, of the stock. The value of the treasury stock should be based on the gross receipts from the disposal of the treasury stock. A review of the information provided by

the taxpayer to the auditor demonstrates that this was the value used; consequently, no adjustment is required.

FINDING

Taxpayer protest is denied.

X. Gross and Adjusted Gross Income –Research Expense Credit

DISCUSSION

Taxpayer's protest of the Calculation of Research Expense Credit was resolved prior to hearing.

FINDING

Issue was resolved prior to hearing.

XI. Gross and Adjusted Gross Income Tax – Negligence Penalty

DISCUSSION

Penalty waiver is permitted if the taxpayer shows that the failure to pay the full amount of the tax was due to reasonable cause and not due to willful neglect. IC 6-8.1-10. The Indiana Administrative Code further provides:

> (b) "Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.
>
> (c) The department shall waive the negligence penalty imposed under IC 6-8.1-10-1 if the taxpayer affirmatively establishes that the failure to file a return, pay the full amount of tax due, timely remit tax held in trust, or pay a deficiency was due to reasonable cause and not due to negligence. In order to establish reasonable cause, the taxpayer must demonstrate that it

> exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed under this section. Factors which may be considered in determining reasonable cause include, but are not limited to:
>
> (1) the nature of the tax involved;
>
> (2) judicial precedents set by Indiana courts;
>
> (3) judicial precedents established in jurisdictions outside Indiana;
>
> (4) published department instructions, information bulletins, letters of findings, rulings, letters of advice, etc.;
>
> (5) previous audits or letters of findings concerning the issue and taxpayer involved in the penalty assessment.
>
> Reasonable cause is a fact sensitive question and thus will be dealt with according to the particular facts and circumstances of each case.

45 IAC 15-11-2.

For the four years of this audit period, taxpayer engaged in numerous activities that gave rise to the preceding issues. While taxpayer's positions were not uniformly upheld, most were based, at least in part, on reasonable interpretations of Indiana's tax statutes. Issue 4, the Resource Recovery System, is a notable exception to taxpayer's generally reasonable interpretation of Indiana's tax statutes. Consequently, the negligence penalty will be waived for the tax years 1992 and 1995, but not for the years involving the Resource Recovery System, 1993 and 1994.

FINDING

Taxpayer protest sustained in part and denied in part.

JM/MR 012708